

THE RICHBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 371

MAY 2004

There is but one means available to improve the material conditions of mankind: to accelerate the growth of capital accumulated as against the growth in population. The greater the amount of capital invested per head of the worker, the more and better goods can be produced and consumed. This is what capitalism, the much abused profit system, has brought about and brings about daily anew. Yet most present-day governments and political parties are eager to destroy this system.

— Ludwig von Mises, *The Anti-Capitalistic Mentality*, 1972

U.S. BUBBLE ANATOMY

Opinions and expectations in the markets are changing rapidly. Yesterday everybody brooded about the dangers of deflation. All of a sudden, the agonizing is about impending inflation because the U.S. economy might be growing too fast, and this could force the Federal Reserve to raise its short-term interest rate in the near future.

Around the world, hopes are running high that with surging domestic demand the U.S. economy is again taking over as the world economy's locomotive. For sure, this is the most important issue at this juncture in the world economic development. This induced us to do a comprehensive analysis of economic and financial conditions underlying the U.S. economy's growth in the recent past.

The U.S. economy has been outperforming those of the eurozone and Japan for years. That is definitely true in terms of quantity as measured by inflation-adjusted gross domestic product (GDP), being the number one statistic on which general attention is focused.

But the U.S. economy's performance in employment has been by far the worst in the world during the past few years. Extraordinary productivity growth is the convenient, cheerful explanation, but one that makes no sense to us.

Comparing the U.S. economic performance during the last few years with that of the eurozone, for example, ought to start with the observation that the U.S. authorities, in contrast to those in the eurozone, have bombarded their economy and financial markets during the past three years with fiscal and monetary stimuli of unprecedented magnitude. That is one aspect of crucial importance; the other is the traction achieved by these policies, both in the U.S. economy and in the financial markets.

Drawing comparisons with the momentum and pattern of past postwar business cycles, we have always emphasized that the present economic recovery is unusually weak and grossly imbalanced, completely lacking the qualities for a self-sustaining recovery.

Due to the accumulation of the fiscal and monetary stimuli in the second half of 2003, recent GDP growth has been on the high side. While the consensus simply extrapolates this acceleration to mean future growth, we see various developments that are aborting the recovery.

BEYOND FLEXIBILITY

The consensus expectation among economists is that U.S. GDP growth will continue to expand at an above-trend pace for the foreseeable future. Thus, the most recent blue chip consensus was for 4.7% growth this year and 3.8% in 2005, with other surveys conveying the same message.

Implicit to the generally prevailing rosy outlook for the U.S. economy is the notion that the outstanding flexibility of corporations and consumers enables it to cope efficiently with all problems. In a recent speech,

Federal Reserve Governor Donald L. Kohn declared that the so-called “carry trade” — borrowing at 1% to invest in much higher-yielding bonds — is “*part of the efficient functioning of markets*” in America.

We realize that this kind of thinking is ubiquitous among American economists. It reminds us strongly of George Orwell’s *1984*, where the Ministry of Truth arbitrarily determines the meaning of words: “*War is Peace. Freedom is Slavery. Ignorance is Strength.*”

In essence, the Fed’s Mr. Kohn said that America’s monstrous bond bubble has nothing to do with artificially low interest rates and the loosest monetary policy in history, both set by the Fed, but that it reflects the supreme efficiency of the U.S. financial markets.

When America’s equity bubble collapsed in 2000–2001, the Fed’s immediate aggressive monetary easing succeeded in stirring three new bubbles — the huge carry trade of bonds, housing prices and mortgage refinancing — that increasingly offset the negative effects of the bursting equity bubble on consumer wealth and consumer spending.

In congressional testimonial in spring 2002, Fed Chairman Alan Greenspan congratulated himself with the remark, “*The imbalances that triggered the downturn and that could have prolonged this difficult period did not fester.*” In his view, information technology, together with financial innovation and deregulation, had made it possible to “*address and resolve economic imbalances far more rapidly than in the past,*” and thereby reduce cyclical swings in economic activity.

It is Mr. Greenspan’s secret what he really meant with his remark about “*imbalances*” that “*did not fester.*” Uppermost in his mind, we suspect, was the plunging stock market devastating personal wealth. As to the rampant consumer borrowing and spending binge and the associated collapse of personal saving, in all his speeches he never alluded to them as imbalances that need to be addressed. He always appeared to regard the two as the solution.

In fact, during 2001–2003 the Greenspan Fed has done everything in its power to maintain, if not to escalate, the running consumer borrowing and spending binge. With short-term interest rates already at a rock-bottom level, in 2003 it undertook an orchestrated forensic campaign to talk down long-term rates also by hinting at possible Fed purchases of bonds. America’s huge financial community listened and obliged by doing the buying for the Fed.

It proved a most successful ruse. The consumer borrowing and spending binge catapulted to new extremes. The annual increase of consumer mortgage financing virtually doubled over the three years between 2000–2003, from \$376.7 billion to \$758.1 billion.

For sure, this credit explosion reflects extraordinary financial flexibility on the part of borrowers and lenders. But what these numbers really say is that America’s central macro imbalance, the consumer borrowing and spending excess, has been growing from bad to worse. This was unquestionably decisive in cushioning the downturn. But strictly speaking, this was undesirable financial flexibility that sustained, and even worsened, the existing macro imbalances.

UNPRECEDENTED STIMULUS

This takes us to the main issue of current economic development in the United States — the efficacy of the massive monetary and fiscal stimulus of the past three years. It is an entrenched view among American economists that sufficient monetary ease is able to avoid a recession under all circumstances, regardless of what happened during the prior boom. In this view, America’s Depression in the 1930s as well as Japan’s present prolonged debacle had their overriding cause in the failure of both central banks to act promptly and aggressively enough.

From the start, Mr. Greenspan made it quite clear he would therefore handle matters very differently. He did deliver by cutting the Fed’s policy rate fully 13 times and some 550 basis points over 2001–2003. At the same time, the government assisted with massive fiscal stimulus on top of the massive monetary stimulus.

It appears to be the overwhelming view, by no means only in the United States, that the two combined

policies have all in all been a success. The usual main arguments are the unusual mildness of the U.S. recession in 2001 and favorable comparisons with distinctly slower economic growth in most other countries, especially in the eurozone.

We diametrically disagree with this view. These favored comparisons only serve to hide a policy traction that has in reality been highly disappointing. Assessing the U.S. economy's recent development has to start by considering the prodigal measures taken both by the central bank and the government to stimulate a recovery.

While the Fed was unique in the world in the speed and size of its rate cuts, the U.S. government was unique in the speed and size of its fiscal stimulus through tax cuts and higher spending.

Within just three years, 2000 to 2003, the U.S. government's fiscal easing had moved from a surplus of around \$100 billion to a deficit of almost \$500 billion at annual rate in the second half of 2003. In total, this equaled more than 5% of nominal GDP. During the same period, the aggregate budget deficit of the countries in the eurozone grew from 0.9% to about 2.7% of GDP — that is, by 1.8 percentage points of GDP.

At the same time, consumer borrowing, propelled by record-low interest rates and easy availability of credit, accelerated to exponential expansion. Faced with sharply slowing income growth, the American consumer has borrowed as never before in the past few years. His overall indebtedness increased by \$879.9 billion in 2003, after \$775.7 billion in 2002, and \$645.4 billion in 2001.

BUBBLE ECONOMIES GUZZLE CREDIT

Altogether, the Fed has come to juggle with three asset bubbles: bonds, stocks and housing, of which the bond bubble plays a key role because it determines the longer-term rates at which most of the borrowing actually takes place. Carry trade in longer-term bonds — borrowing short around 1% and investing with leverage of at least 20:1 into longer-term bonds (U.S. Treasury, mortgage-backed, asset-backed and GSE securities) yielding around 4% and more — has become the backbone of America's financial system, running now into several trillions of dollars year over year.

The trouble with bubble economies is that they devour credit and debt like the famous “guzzler” automobiles used to devour gasoline. The essential reason is that a bubble economy needs credit for two different purposes: first, for inflating asset prices; and second, for the spending binge on current goods and services.

Total U.S. indebtedness is now at around \$35 trillion. Of this total, about \$15 trillion, or 40%, accrued over the six bubble years since 1997. This compares with an increase of nominal GDP over this period by \$2.68 trillion. Clearly, the overwhelming part of the rampant money and credit creation poured into asset markets, fueling asset price inflation, now hailed in America as the nation's wealth creation.

In times of slowing economic growth, it used to be the regular experience that overall borrowing and lending sharply slowed. This time, the exact opposite has happened. Over the three years of subpar growth, 2001–2003, overall credit has risen exponentially, far faster than in the prior three boom years of 1998–2000: \$7.1 trillion versus \$5.9 trillion.

Strikingly, outstanding debt of the financial sector has more than doubled since 1997, from \$5,532 billion to \$11,402 billion, obviously reflecting the escalation of financial speculation and leveraging. During the three years to 2003, it accounted for one-half of total borrowing. Carry trade of bonds certainly plays the greatest role.

If you think it over, it is bizarre economics: Private households stampede into debt to purchase houses and corporate stocks, incidentally driving up their prices. Rising market values then serve them as collateral for still higher borrowing. The obvious knack is that the asset purchases work with leverage on asset values, rising faster than the debts.

LOOKING FOR POLICY TRACTION

For sure, this is a radically new pattern of generating economic growth and prosperity. It vividly reminds us of a German fairy tale about a man called Münchhausen who pulled himself out of a swamp by his own hair. This

is Münchausen economics in America.

The overall monetary and fiscal policy stimulus implemented to the U.S. economy during the last two years was certainly the most prodigal in history. The most important question now, of course, is the success of this policy in achieving a sustained economic recovery.

The customary measure is the inflation-adjusted real GDP. Over the two years following the recession of 2001, it was up 5.9%. Always pointing to weaker economic growth in Europe, consensus opinion believes U.S. economic growth is an impressive policy success. But compared with postwar U.S. cyclical recoveries, averaging 10.2% over the two years following recession, policy traction has, in actual fact, been extremely anemic even by this measure.

In other highly important gauges of economic performance and well being, such as employment, incomes and production, policy traction is completely elusive. Following past postwar recessions, employment growth in the private sector averaged 6.6%. As wage rates rose in addition, real wage and salary income even surged by 9%.

Over the two years 2002–03, following the last recession, wage and salary disbursements of the private sector edged up just \$70.9 billion, or 1.7%. That was in current dollars. Deducting the rise of the inflation rate, real incomes from wage and salary disbursements in the private sector have fallen.

We come to the great paradox of these two years, of which very few people are aware.

Backed by strong income growth, consumer spending grew over the same two years by \$712 billion in nominal terms and by \$460.6 billion in real terms, accounting thus for the bulk of GDP growth.

While income growth from private sources abruptly stalled, disposable personal income nevertheless surged in 2002–2003 at a respectable average annual rate of 4.9%. What did it? The government opened its money spigots as never before through tax cuts, sharply higher social benefits and wage increases.

Declining taxes, first of all, boosted disposable income from \$474.3 billion before tax to \$730.6 billion after tax, providing a net income gain of \$256.3 billion. The government's social benefits increased \$189 billion, and government wages and salaries rose another \$82 billion. With these three items adding up to \$521 billion, fully 72% of total personal income growth in 2002–2003 came from the government.

What about personal income growth in the private sector? Its two main sources are wage and salary disbursements and income receipts on financial assets, mainly stocks and bonds.

Wage and salary disbursements have grown over the two years of 2002–2003 by \$70.9 billion. In 2000, the last year before recession, they had grown \$317.6 billion. Rarely mentioned or considered are the growing losses that America's savers are suffering on their interest income. In late 2003, it was down to an annual rate of \$947 billion, compared with \$1,011 billion in 2000. Taking inflation rates and taxes into account, the American saver is facing financial devastation.

However, for many consumers these dreadful facts are drowned in the general rejoicing about soaring wealth gains from rising stock and house prices, offering more and more collateral for more and more borrowing. Regardless of the immense fiscal benefits, consumer borrowing, too, has been setting ever-new records, hitting \$879.9 billion in 2003, after \$775.7 billion in 2002, together \$1,655.6 billion.

But what happened to all this borrowed money, considering that thanks to fiscal largess, the rise in current spending was more than matched by the rise in current disposable income? As explained earlier, it needs heavy borrowing just to keep house and stock prices inflating. Most of the consumer borrowing went into the purchase of housing, shares and mutual equity funds.

The most crucial consideration now is whether or not the lavish policy measures of the past few years in the United States have established the conditions for a self-sustaining U.S. economic recovery of normal breadth and strength.

MISSING RECOVERY DYNAMICS

For a first, preliminary answer, just two remarks: By any measure, the U.S. economy's recovery during 2002–2003 has been exceptionally weak, and achieving it needed the most lavish monetary and fiscal policy. Just as odd has been its pattern. Past cyclical recoveries occurred across all demand components of the economy, with residential building and business fixed investment heading the advance. In contrast, the recovery of 2002–2003 reflected little more than the big fiscal stimulus and the consumer and spending binge.

Autonomous growth dynamics remain flatly missing. Without the government's huge income injections, the U.S. economy would even have badly slumped. What's more, the persistence of extreme monetary looseness over several years has turned the U.S. asset markets across the board into an unprecedented array of different asset bubbles, essentially implying high fragility.

Without question, America's economy is an unmistakable case of a bubble economy. By definition, this implies two main features: *first*, sharply rising asset valuations are driven by extremely loose and cheap credit; and *second*, the rising valuations, in turn, serve directly or indirectly as collateral for credit-financed spending on consumption or investment.

However, in the conventional discussion of the U.S. economy, the word “bubble” has been flatly tabooed. Again we cannot help but think of Orwell's Oceania, where the Ministry of Truth has decided that asset bubbles must be unreservedly hailed as the new kind of wealth creation. With utter amazement we read and hear from all sides the new siren song that wealth creation through rising asset prices is really the most intelligent, and above all the quickest, way for a nation to get richer.

Yet it is widely hoped and believed that two highly important traditional growth dynamics are at long last falling into place — employment and business investment.

THE JOB FRAUD

On April 2, the U.S. Department of Labor announced that nonfarm payroll employment in the United States had surged by 308,000 in March, allowing the administration to claim that the job recovery had finally arrived. After taking a closer look, we concluded that was just another case of absurd statistics.

The monthly employment situation report of the Labor Department is based on two different surveys, the household survey data and the establishment survey. The first is a sample survey of 60,000 households conducted by the U.S. Census Bureau for the Bureau of Labor Statistics (BLS). The second is conducted by the BLS in cooperation with state agencies, and includes 160,000 businesses and government agencies covering about 400,000 individual worksites.

According to the household survey, civilian employment increased from 137,384 million in February to 137,691 million in March, up 307,000. These are the raw, not seasonally adjusted, figures. Usually, employment rises in March due to seasonal effects. Accordingly, indeed, the seasonally adjusted data for March shows a decline by 3,000. In other words, zero job growth.

In the establishment survey, the raw numbers are even much worse. Nonfarm payrolls, not seasonally adjusted, increased by just 7,000 in March, as against 307,000 in the household survey. Now you would expect that seasonal adjustment would produce an even steeper decline than in the household survey. Miraculously, seasonal adjustment went in a diametrically opposite direction, turning the paltry raw number of 7,000 into a seasonally adjusted spectacular jump of 308,000.

Wondering how this is possible, we found out that virtually half of this big employment gain owed to a statistical method called the “net birth/death model.” The BLS explains that due to its “*inability to capture, on a timely basis, employment generated by new firms,*” it feels the need to use some special adjustments.

“To correct for this systematic underestimation of employment growth, an estimation procedure with two components is used to account for business births. The first component uses business deaths to impute employment for business births.” In essence, this means the more businesses are being liquidated, the more new

jobs through business births are “imputed.” The second adjustment component is the X-12-ARIMA software model, being used to account for seasonal effects on the net birth/death ratio.

In March, the two methods of calculation had a dramatic result: 153,000 of the 308,000 new jobs derived from the “net birth/death model.” The other half of the alleged job growth came mainly from two sectors: construction (71,000) and retail trade (47,000).

Again, according to the household survey (seasonally adjusted), employment in private industries fell by 175,000; the number of self-employed workers fell by 288,000. If there had not been a steep increase in government employment by 439,000, the March job report would have been a disaster.

Last but not least, another oddity from the establishment survey: Average weekly hours fell in March; in fact, they fell so much that total hours worked declined even as the work force surged.

...AND PROFIT ILLUSIONS

Surprisingly good news has also come lately about U.S. business profits, suggesting to the consensus an implicit strong stimulus to lagging business fixed investment. To transform the weak recovery of the past two years into a self-sustaining, vigorous expansion, it definitely needs strong hiring and capital spending by businesses.

First, for perspective: During the first two years following past postwar recessions, the rise in spending on fixed investment in real terms averaged 21.4% for business durable equipment, 4.8% for business structures and 36.7% for residential building. The vigorous cyclical recoveries of the past all received their crucial, primary upward push from strong, autonomous investment, with consumption passively responding to rising incomes.

Now the equivalent numbers for the period from end-2001 to end-2003 for comparison, again all in real terms: business equipment and software up 11.8%%, non-residential structures down 15.7% and residential building up 17.2%. Clearly, it is so far an exceptionally weak investment recovery. Moreover, it started very late. Thus, the strong investment-related income creation, typical of past recoveries, could not take place.

It is widely believed in the United States that business spending on investment typically follows changes in consumer spending. Its delay during the past two years appears, in this view, quite normal. In reality, this assumption of consumption-led investment spending diametrically contradicts all empirical evidence.

Sharply higher profits are lately stirring hopes that stronger investment spending by businesses is joining the consumer-spending spree. As the following table shows, again the devil lurks in the details.

A VERY MIXED PROFIT PICTURE

	1997	1998	1999	2000	2001	2002	2003
Domestic Industries*	868.5	801.6	851.3	817.3	770.4	904.2	1,069.9
Domestic Industries**	701.4	635.5	655.3	613.6	544.4	589.4	678.7
Financial	193.0	165.9	194.3	200.2	225.6	255.1	268.8
Nonfinancial	508.4	470.1	461.1	413.4	318.8	334.3	410.0
Manufacturing	209.0	173.5	175.2	166.3	54.0	73.3	96.6
Durable goods	103.1	83.4	72.3	60.0	-24.9	8.8	20.2
Nondurable goods	105.9	73.6	78.3	84.3	78.9	64.6	76.4
Wholesale trade	47.6	52.3	55.5	59.7	51.6	49.1	45.4
Retail trade	64.2	73.4	65.2	59.6	71.1	76.7	80.1

*Corporate profits with inventory valuation and capital consumption adjustment

** Corporate profits with inventory valuation adjustment

Source: National Economic Accounts, U.S. Department of Commerce

These numbers, all from the official national income and product accounts (NIPA), certainly paint a highly conflicting picture. For obvious reasons, Wall Street and the media strictly focus on the numbers in the first row, looking by far the best.

There is clearly one big distortion in all profit numbers. That is the tremendous profit opportunities in the financial markets, in particular through the highly leveraged carry trade of bonds. In 2003, the financial sector accounted for 40% of total profits, compared with 5% in the early 1980s. While the firms in this sector, of course, reaped the lion's share of such easy profits, many firms in the nonfinancial sector too have doubtless taken advantage of it, either directly or through financial subsidiaries.

In any case, we ought to focus on the corporate profits in the nonfinancial sector. They too have sharply recovered from their lows in the 2001 recession. Looking at the longer-term trend since 1997, though, there is nothing to boast about, in particular when taking the simultaneous growth of nominal GDP over these years into account. The share of nonfinancial profits in the U.S. economy, measured against GDP, is close to record lows.

The worst performer, by far, for many years already has been manufacturing. Expressed in percentage, its profits are also sharply up from their recession low. But measured in amounts of dollars (see the table on page 6), overall profits of the sector in 2003 were still less than half their amount in 1997.

Scrutinizing the numbers, we made another shocking observation. Within the manufacturing sector there is a dramatic divide in the profit performance between the producers of durable goods and those of nondurable goods. In 1999, the first group earned overall \$72.3 billion, almost half of total manufacturing profits (\$150.6 billion); in 2003, it earned just \$20.2 billion of overall manufacturing profits of \$96.6 billion.

On closer look, the bulk of the bad numbers comes from four branches of manufacturing: machinery, computers and electronics, electrical equipment, and motor vehicles. Apart from the latter, they are really the heart of the New Economy. Producing capital goods is, obviously, very bad business in the United States.

And just as obvious is its underlying main cause. This extremely lopsided profit pattern perfectly conforms to the extremely lopsided demand pattern that has been prevalent in the United States for years, and actually continues to prevail. Consumer spending, propelled by unprecedented stimulus and credit accommodation, has been taking a growing share of spending at the expense of savings, investment and the trade balance.

IT IS TRULY DIFFERENT THIS TIME

Attempting to assess the U.S. economy's further outlook, one should first ponder the main causes that have been thwarting stronger and healthier recovery, even though monetary and fiscal policy have acted with an aggressiveness that has no precedent in history. For most American economists, sufficiently easy money is of infallible efficacy. The few instances in history when record-low interest rates persistently failed to work, like recently in Japan and during the 1930s in the United States, are summarily discarded with the argument that central banks failed to act fast enough.

During the whole postwar period, it has, in fact, been typical that depressed economies promptly took off once central banks eased. Yet for us this was never proof of the efficacy of monetary policy. Since all postwar recessions had their cause in monetary tightening, it was only natural that economies promptly jump-started when central banks loosened their brakes.

But the situation today is radically different. For the first time in the whole postwar period, the U.S. economy slumped against the backdrop of rampant money and credit growth. But if tight money or credit did not break the boom in 2000, it is hard to see how easy money can be the cure.

Identifying the true causes of the U.S. economy's poor economic performance in recent years is certainly a most important task. During 2003, leading Fed members propagated the idea that the U.S. economy was mainly suffering from an "*unwelcome fall in inflation*" — according to the title of a speech by Fed Governor Ben S. Bernanke, on July 23, 2003, at the University of California, San Diego. In more detail, he said that lack of pricing

power was seriously impinging upon corporate profits, which in turn had strangled business capital investment.

Considering that the U.S. economy had been booming with the most rapid money and credit growth in history, this was an absurd conclusion. Several Fed members, in any case, exploited the temporary deflation scare they had raised to implant expectations for sharply lower long-term interest rates into the markets — with the desired effect that the financial community, with its huge speculative firing power, quickly obliged with prodigious carry trade.

What, then, brought the U.S. economy down in 2000? In short, several years of unprecedented credit excess. We realize that this is unthinkable for many people. Yet it is a notorious historic fact that serious depressions are always preceded by extremely loose money and extraordinary credit excess. Tight money is too easily reversible to cause a deeper crisis. Ironically, it was always low inflation rates that misled central banks to excessive credit accommodation.

The two worst cases of this kind in history are, of course, the U.S. boom-bust from 1927 to the 1930s and Japan's boom-bust since 1987. In both cases, extraordinary asset bubbles played a key role in escalating credit excess. The third, and probably worst, case of a "bubble economy" is the United States for the past several years.

Credit excess thwarts economic growth even in the absence of monetary tightening through effects ambiguously known in Austrian theory under different labels: *structural maladjustments, distortions, dislocations, imbalances and dislocations*.

The imbalances most often cited are a rock-bottom national savings rate of 1% of GDP, record levels of personal indebtedness, a record current account deficit, a record-high budget deficit, a record ratio of household indebtedness and an unprecedented shortfall of employment growth and labor income generation.

But there are important others that are totally ignored. One of them is the tremendous gap that has developed in the United States between virtually stagnating production of goods and soaring demand, as measured in retail sales. While the latter have been going from record to record, manufacturing production, which should deliver most of the goods sold in the shops, has been badly lagging. The soaring difference went, of course, into the soaring trade deficit.

For more than two years, the Fed has been holding its short-term rate at 1%. That is, below inflation. But instead of spurring economic growth directly, it stimulated sharply rising prices in almost all major asset classes, which in turn stimulated spending, mainly consumer spending. Rising property values and the increasing ability and willingness of homeowners to tap accumulated housing wealth became the major pillars of support both for the economy and also — given minimal personal savings — for the asset markets.

The all-important question now, of course, is whether this ultra-loose monetary policy and the associated development of asset prices have laid the foundation for a normal, self-sustaining economic recovery. President Bush talks about an "*ownership society*" — and has boasted of how the wealth of average Americans has increased because of soaring housing prices and rebounding 401(k)s.

A GROTESQUE MISNOMER

Economic growth now depends crucially on the strength of wealth and profit creation. Mr. Greenspan and the bullish consensus economists claim that America has its highest rate of wealth creation in history — through rising asset prices.

Fed members are claiming that this is a perfectly normal transmission mechanism of monetary policy. That is an outright lie. Never before have inflating asset prices been a key driver of real economic activity.

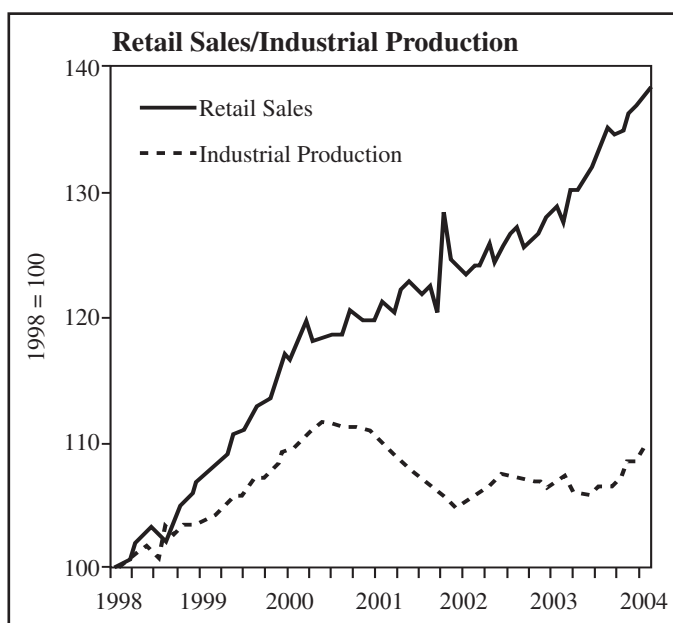
To be sure, asset prices always rise in the early stages of a cyclical economic recovery in response to monetary easing. But such increases did little or nothing to boost economic growth.

First of all, they were very limited in size, in particular for housing; and second, there was no way to convert them into cash, because the reckless lenders of today did not exist. Besides, Americans of the 1960–1970s would have been too proud to practice it and too intelligent to mistake it for wealth creation. There is no

precedent for such profligate behavior of private households.

Worst of all, it is no wealth at all. That is strikingly obvious from the macro perspective. The best way to realize this, we think, is a comparison with the true wealth creation that generations before us have experienced and that generations of economists have regarded as the one and only way to greater, lasting prosperity. It comes from investment spending on income-creating buildings, plant and equipment.

Investment spending creates demand, employment and incomes in the first instance through the production of the necessary capital goods. When finished and installed, the new capital goods go on their part into production, creating further employment, incomes and demand. And most importantly, debts incurred in connection with this wealth creation are self-liquidating through the underlying income creation.



And what really happens to incomes and debts in the case of so-called wealth creation through appreciating asset prices? Nothing at all. Generations before us never thought of it as wealth creation. It arises principally from a general convention to consider total outstanding assets of a certain category as being worth the price of the last trade, however small that trade may have been. Clearly, small trades have tremendous capitalization effects. For good reasons, such so-called wealth creation is not practiced in most countries.

In Japan's case, the principal beneficiaries of the asset bubbles in the late 1980s were industrial and real estate business. In the U.S. case, it is the consumer. But in order to enjoy the wealth effects of rising stock and housing prices, he had to encumber himself with soaring debts to afford the price-driving asset purchases.

For Mr. Greenspan and the bullish consensus it is a virtuous circle, as the overall gains in capitalized asset prices have outpaced the rise in debt levels. Implicitly, the big net gain in asset values can be used as collateral for borrowing that fund's higher spending for consumption.

In their economic effects, the two patterns of wealth creation have manifestly nothing in common. The key feature of the capital investment model is correlated increases in current and future incomes. It boosts economic growth both in the short and in the long run. What's more, the associated initial rise in corporate debt amortizes itself through the following depreciations.

The striking key feature of so-called wealth creation through asset bubbles in favor of the consumer is first of all the associated record production of debt, as against total absence of income creation. To maintain demand creation through this kind of wealth creation, it obviously needs ever more debt creation; *first*, to keep the asset prices inflating; and *second*, to fund the spending on consumption.

Thinking it over, one realizes that "wealth creation" is really a grotesque misnomer for asset prices that are rising out of proportion to current income. The economic reality is not wealth creation, but impoverishment. We repeatedly hear from Americans that they are living in houses or apartments they could not afford to buy with their present incomes. But with their incomes and prices what they were many years ago, they could afford the purchase. That says it all.

The writing has been on the wall for years. In 1996 the American consumer increased his spending on current goods and services by \$281 billion, with debt growth of \$345.7 billion. In 2000 he spent \$456.9 and borrowed \$566.9 billion. And in 2003 spending of \$367.9 compared with debt growth of \$879.9 billion.

But consumer borrowing was not alone in escalating to unprecedented extremes. So did government

borrowing, and in particular borrowing for boundless financial speculation.

In 1997, the U.S. economy grew by \$487.4 billion in current dollars, with an overall credit expansion of \$1,406.8 billion. That was already an unusually high borrowing ratio. In 2003, it took \$2,717.5 billion of new credit to generate nominal GDP growth of \$504.7 billion.

Credit excess — always due to artificially low interest rates — implicitly means spending excess. But the problem is that these spending excesses tend to distribute very unevenly across the economy. In the United States, for years they have been overwhelmingly directed towards the whole range of asset markets — stocks, bonds, housing — and in the economy towards consumption.

Given the enormity of these credit and spending excesses, it goes without saying that they have involved tremendous distortions in the economy's whole structure, being typically located in three areas: *first*, they misdirect output; *second*, they distort relative prices, costs and profits; and *third*, they strain balance sheets.

It used to be a truism among policymakers and economists that for an economy ailing from such structural distortions, a return to sustained growth is only possible after these have been significantly moderated, if not removed. Mr. Greenspan has plainly opted for the diametrically opposite strategy to fight economic weakness, regardless of existing maladjustments through more and more credit excess.

Pointing to the U.S. economy's rates of real GDP growth, Mr. Greenspan claims full success for his policy. Compared with the far higher rates of growth of past cyclical recoveries, his policy has grossly failed, even by that measure. But considering the horrible development of employment, it has been a policy disaster.

THE INTEREST RATE SHOCK

Admittedly, though, most recent statistical releases of data about the U.S. economy are unusually contradictory and confusing. Contrary to the general perception, consumer spending in the first two months of this year drastically slowed to the point where real outlays virtually stagnated (Bureau of Economic Analysis: Personal Income and Outlays, March 26, 2004, page 13).

For us, this was the single strongest indication that the U.S. economy was slowing.

But then came the much-stronger-than-expected reports about employment, retail sales, housing starts and durable goods orders for March. Investors seem to have made a hasty switch from worrying about the sustainability of the U.S. economy's recovery to concerns that too much strength might damage the Fed's low interest rate policy.

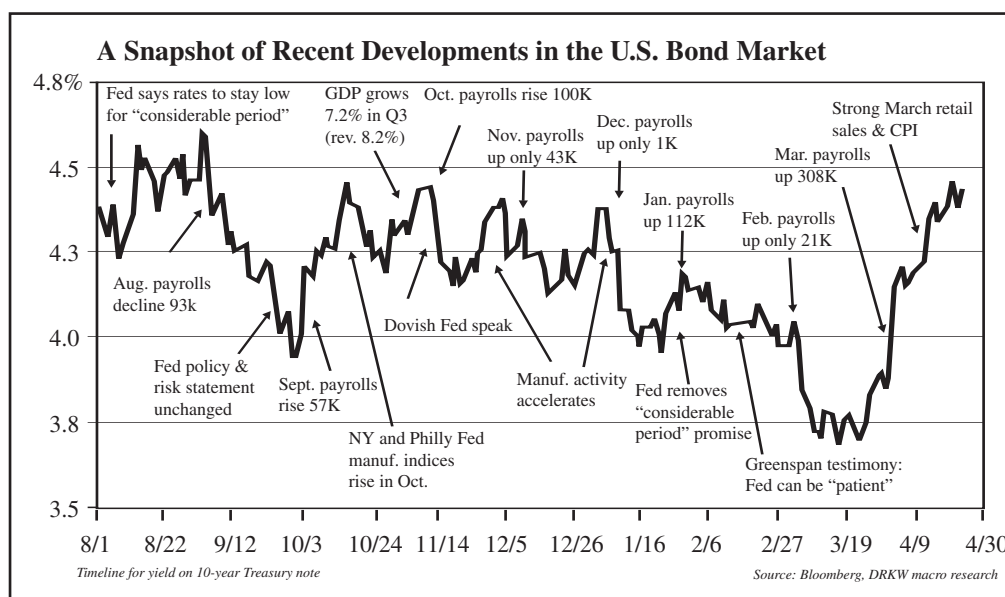
Scrutinizing the data in the search for truth, we quickly stumbled over things that struck us as strange or contradictory, like the employment report, which we analyzed in some detail. In the case of the stellar durable goods orders, it perplexed us that their steep rise coincided with a decline in production by 0.2%.

From *The King Report* we learned that inflation-aided industries — primary metals (+7.2%) and fabricated metals (5.2%) — performed best. On the other hand, orders for computers rose only 0.2%. And get this: Nondefense capital goods shipments fell 11.6%. So much for the heralded investment boom that will boost employment.

Our great skepticism versus the highly optimistic forecasts has three main reasons: *first*, even with the prodigal monetary and fiscal stimulus this U.S. economic recovery entirely lacks both the momentum and the qualitative pattern of past recoveries; *second*, fiscal and monetary policy have virtually spent their power. But *third*, and most importantly, the crucial pillar of support for consumer spending — inflating asset bubbles and equity extraction from homes — is in jeopardy.

There is much agonizing whether and when the Greenspan Fed will raise interest rates to fight inflation. Several Fed members were quick to emphasize in public their determination to act, if necessary. For us, all this is empty talk. Today's Fed will never "take the punch bowl away," because the risk of shattering the extremely vulnerable bond market is far too big.

In the absence of true savings, and no new savings, this market is completely built on leveraging. The typically practiced leverage of 20 to 1 requires just 5% equity. But a fall in bond prices by that tiny ratio would wipe out the players' equity on trillions of dollars of bond holdings in carry trade. In actual fact, this almost happened during the last few weeks, with the benchmark 10-year Treasury yield abruptly jumping 75 basis points to 4.4%.



Reacting so quickly and sharply to a few stronger economic data and the reported higher inflation rates for March testifies, of course, to the market's enormous sensibility and vulnerability — a \$22 trillion market, by the way. We have no doubt that "they" massively intervened in the futures markets to prevent worse. To note, the biggest players are banks and hedge funds.

A DEVASTATING COMPARISON BETWEEN 2003 AND 2002

Assessing the impending prospects for the U.S. economy, the consensus simply extrapolates last's year acceleration, completely ignoring that the last two years benefited tremendously from the temporary, most prodigious fiscal and monetary stimulus. But both have spent their power. What disturbs us in the first place is the poor traction this entire stimulus really had.

Between 2002–2003 nominal GDP growth accelerated from 3.8% to 4.8%, and real GDP growth from 2.2% to 3.1%. What regularly impresses people are only the annualized quarterly numbers. Measured from fourth quarter to fourth quarter, real GDP grew 4.3%, after 2.8%. In actual amount, nominal GDP rose \$504.7 billion, from \$380 billion. The gain, in short, was \$124.7 billion.

Now, please compare this gain with the lavishness of the stimuli applied. Current taxes of private households fell \$64.4 billion in 2003, while government payments for social benefits expanded \$82.1 billion. This followed a far bigger fiscal stimulus in the year before.

But the artificially low interest rates, working through an array of asset bubbles, opened the money and credit spigots for the consumer as never before. On top of the increase of his current income by \$293.4 billion, he borrowed \$879.9 billion last year. The main source of all this borrowed money was the interplay between the housing, bond and mortgage refinancing bubbles. Overall, the consumer had almost \$1,200 billion at his disposal in 2003, of which he spent \$369 billion on current goods and services.

And where did the greater part of his money go? In short, into asset purchases — stocks, houses, apartments, etc. — inflating their prices. Remember, "wealth creation" through inflating asset prices first requires that the buying of the assets inflates their prices, creating thus the collateral for still more borrowing. It is the dream of a credit machine generating its own fuel for more and more lending.

Nevertheless, there are limits, if not set by the central bank, then set by the markets. Over the last two years, ample mortgage refinancing fueled the housing and stock market bubbles. Consider that the consumer borrowed \$1.68 trillion during 2002–2003, mainly from this source.

But the key condition to drive this borrowing frenzy was that Fed policy had pushed the rates for new mortgages substantially below the rates of existing mortgages, making refinancing highly attractive. It should be clear that a rise in current mortgage rates relative to rates on existing mortgages, of course, has the opposite effect of sharply slowing, if not crushing, the refinancing game.

In other words, it would prick the whole U.S. bubble economy.

Given the recent rise in U.S. long-term interest rates, this might well have begun, implying a sharply diminished flow of new liquidity.

CONCLUSIONS:

According to surveys, bullishness about the U.S. stock market and the economy is presently close to record levels. Yet the market itself has been shrugging it off for months with a lackluster performance. Now, even with economic and earnings news at their best in years, it is going into an accelerating downturn.

Essentially, the pundits are pondering the reasons. Of course, U.S. stocks are again at ridiculous levels, already accounting the best of all worlds. Fears of a rate hike by the Fed are another plausible reason.

For the sake of the Fed's credibility, Mr. Greenspan vaguely confirmed this possibility. In reality, he must be desperate to avoid it because any tightening of significance would quickly prick one bubble after another.

The first to be hit is the extremely vulnerable carry-trade bubble in bonds. The problem is that, due to its extremely high leverage, rather small rises in rates could pull the rug out from under the whole carry trade. It is many times worse than Long-Term Capital Management (LTCM).

Rising long-term rates, in turn, cut off the huge liquidity flows that the consumer has enjoyed over the last two years from mortgage refinancing. Suddenly deprived of this prodigious liquidity source, he has to slash his spending on home building, the stock market and consumption. Running suddenly out of borrowed money, the consumer faces sudden illiquidity. Through the collapsing carry trade, a mere 1% rise in long-term rates would be enough to ram the whole U.S. economy and its financial system into a devastating liquidity crisis. But that would push rates even higher, not lower. From this perspective, the sudden sharp decline of the gold price also greatly disturbs us.

THE RICHBÄCHER LETTER

Dr. Kurt Richebächer, Editor
Published by Agora Publishing Inc.
Jeanne Smith, Publisher

Richard Barnard, Associate Editor
Erik Kestler, Editorial Assistant
Mark O'Dell, Graphic Design

For subscription services and inquiries, please write to: THE RICHBÄCHER LETTER, 808 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling (800) 433-1528, or from outside the U.S. by calling (203) 699-2900. Fax (410) 454-0403. Web: www.richebacher.com Subscription rates: in the U.S.: \$497. Outside U.S.: \$545. Published monthly. © *The Richebächer Letter*, published by Agora Publishing Inc. Reproduction is strictly forbidden without written permission. The Richebächer Letter presents information and research believed to be reliable, but its accuracy cannot be guaranteed. The publisher expressly forbids its writers or consultants from having a financial interest in any security recommended to its readers. Furthermore, all other Agora Financial, LLC (and its affiliate companies) employees and agents must wait 24 hours prior to following an initial recommendation published on the Internet, or 72 hours after a printed publication is mailed. Neither the publisher nor the editor is a registered investment advisor. Readers should carefully review investment prospectuses and should consult an investment professional before investing.